



**Subject: FISCAL YEARS 2016-2018 RECOMMENDED BUDGET**

On behalf of my Morgan Hill teammates, it is a privilege to present to you and the community the Recommended Fiscal Year 16-18 Biennial Operating Budget and FY 16-17 through FY 21-22 Capital Improvement Program Budget (CIP). This is the first year of the transition to a two year operating budget cycle and six year CIP. The biennial budget consists of two separate budgets that the Council will consider for adoption. Prior to the conclusion of the FY 16-17 annual budget, the Council will be provided an update on revenue assumptions, fund balances, and possible amendments to the FY 17-18 (or second year) annual budget. A sixth year has been added to the CIP to ensure a five year spending plan is maintained. The budget documents are the product of many employees working in a collaborative manner to align resources and propose service level enhancements that are consistent with the City Council's and community's priorities, while continuing to maintain fiscal responsibility. In implementing the Council's budget, our team strives to advance our organizational values of teamwork, customer service, innovation, meeting challenges, and professional development. I want to acknowledge and thank all of them for their efforts to improve the community we serve. It is an honor to work with such a dedicated, community-focused team of professionals.

The budget process commences in January with the City Council adopting its priorities, goals, and strategies for the organization and community. The Council's ongoing priorities include:

- o Enhancing public safety
- o Protecting the environment
- o Maintaining fiscal responsibility
- o Supporting youth
- o Fostering a positive organizational culture
- o Preserving and cultivating public trust

- o Planning our community
- o Developing our community
- o Enhancing our services
- o Improving our communication
- o Participating in regional initiatives

Furthermore, consistent with the City's previous community engagement and commitment to understanding resident satisfaction and service priorities, the City of Morgan Hill commissioned Godbe Research to conduct a telephone survey to assess resident satisfaction and priorities for City services. The results show constituents are highly satisfied with their quality of life and the services the City provides. An overwhelming majority of 90% of respondents rate Morgan Hill's quality of life as "excellent" or "good." And among several other very positive findings, 92% rate Morgan Hill "excellent" or "good" as a place to live.

Residents identified the following quality of life service priorities:

- Rapid response to 9-1-1 emergencies
- Maintaining the number of police officers on neighborhood patrols
- Maintaining crime prevention and investigation programs
- Maintaining fire protection
- Maintaining city streets and roads, and repairing potholes
- Maintaining the long-term financial stability of the City

To learn more from our residents, the City has recently begun engaging the community further to obtain additional feedback about Morgan Hill's quality of life needs and to ensure as many people as possible have an opportunity to share their views. This includes a survey, meetings with community organizations (Chamber of Commerce, Jackson Oaks Association, etc.), and another survey in July. Results from both the previous and current surveys can be found in the budget document as well as on the City's website.

This priority based budget strategy ensures that the Council's and community's priorities are the guiding principles for developing the biennial operating budget and capital improvement program with the goal of enhancing City services. The proposed budget strives to achieve this goal in a cost effective manner and at all times, long-term financial sustainability is the focus. This includes ensuring that revenues and expenditures remain in balance for ongoing expenditures and one-time expenditures are proposed as resources allow. The proposed budget also continues to take incremental steps to address the backlog of



## Supporting Youth

- Increase the General Fund investment for street improvement projects - \$250,000 annually (ongoing for three years)
- Continue to address the City's unfunded Other Post Employment Benefits (OPEB) liability by contributing to the Trust Fund in the amount equal to the Annual Required Contribution (ARC) so that the unfunded liability decreases over time - \$300,000 annually (all funds)
- Meet the Pension Stabilization Account funding goal of \$500,000 to ensure the City is prepared for any unanticipated PERS rate changes - \$300,000 (one-time all funds)
- Set aside funds for Firearms Replacement program - \$10,000 (ongoing)

- Initiate a three year effort to install decorative crosswalk near community schools as part of the City's safe routes to school CIP - \$100,000 annually (over three fiscal years)
- Support Downtown Investment Strategy and provide additional park spaces by initiating the construction of 3 Downtown parks - CIP \$4,051,000
- Collaborate with the community for the design and construction of a \$4 million inclusive playground that is envisioned to be substantially funded through donations - \$550,000 (one-time)

- Purchase WorkFit height adjustable work stations to allow the Police Department's Records Team to sit or stand while working at their desk - \$5,000 (one-time)
- Investment in City's Information Services infrastructure by continuing exchange server upgrade and

CITY OF MORGAN HILL • FY 16-17 and 17-18 • OPERATING AND CIP BUDGET • CITY OF MORGAN HILL

- ## Preserving and Cultivating Public Trust

- ## Planning Our Community

- ## Developing Our Community

- ## Enhancing Our Services

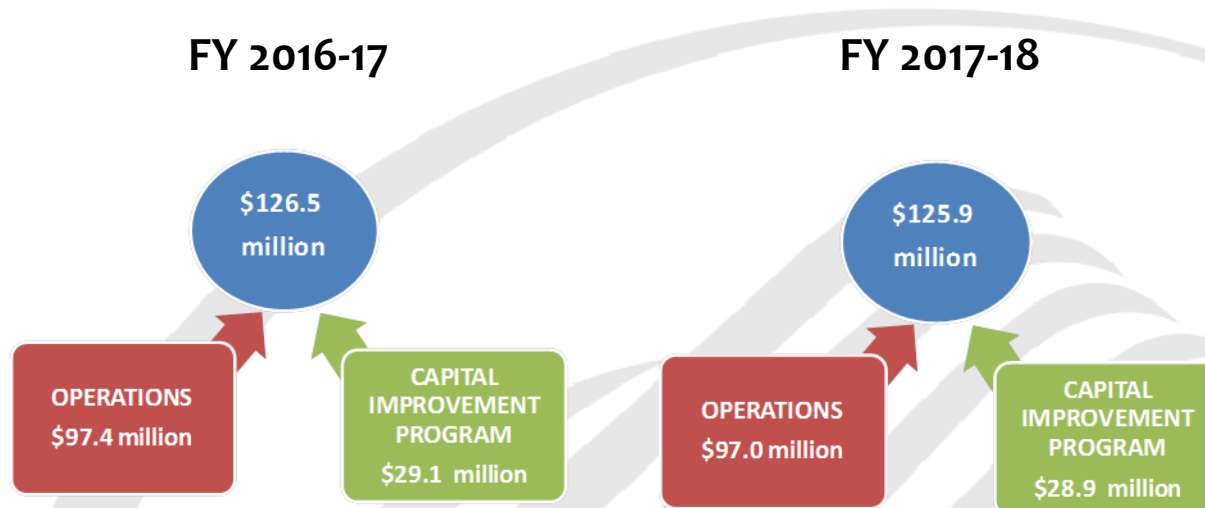
- CITY OF MORGAN HILL • FY 16-17 and 17-18 • OPERATING AND CIP BUDGET • CITY OF MORGAN HILL • FY 16-17 and 17-18 • OPERATING AND CIP BUDGET • CITY OF MORGAN HILL • FY 16-17 and 17-18



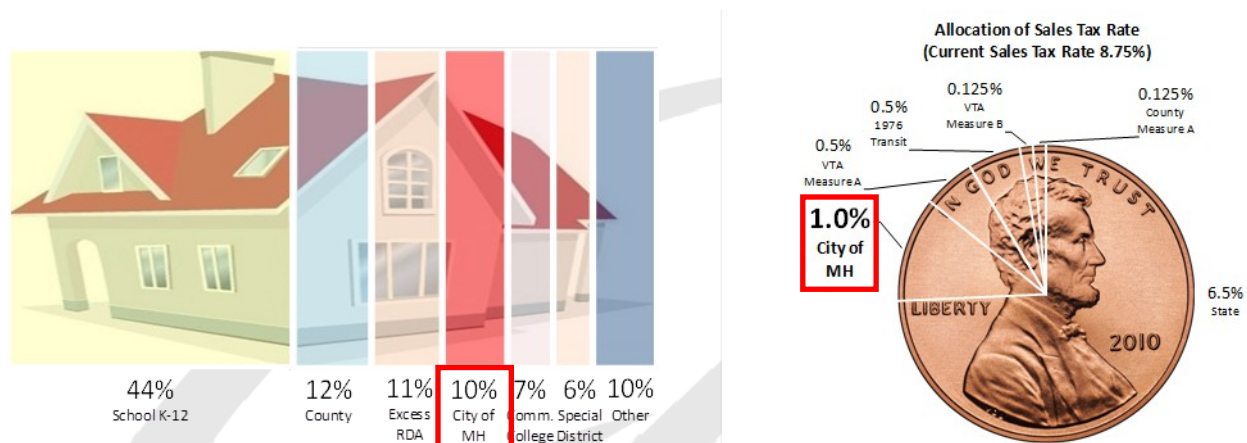
Also included in the Council's workshop discussion were several major studies and initiatives that are underway. These include developing a Public Safety Master Plan, creating an Economic Development Blueprint, evaluating the effectiveness and efficiency of our development services processes and organizational structure, updating the Parks, Recreation, and Trails Master Plan, updating the Water Master Plan, updating the Wastewater Master Plan, and developing a long-term solution for our affordable housing administration. In each case, the adoption of the FY 16-18 operating and capital budgets will occur prior to the conclusion of the necessary work. As a result, it is envisioned that service enhancement budget amendments may be necessary in the months following budget adoption. This could include, but not be limited to, additional capital projects, organizational structure changes, and enhanced services that advance the Council's and community's quality of life priorities.

## Budget Overview

The total Recommended Biennial Budget is \$126.5 million in FY 16-17 and \$125.9 million in FY 17-18 as shown below. This includes all expenditures in two major categories; 1) operations and 2) capital projects. A detail of each project description and funding requirements for FY 16-17 and FY 17-18 can be found in the accompanying operating departments and Capital Improvement Program sections of this document.

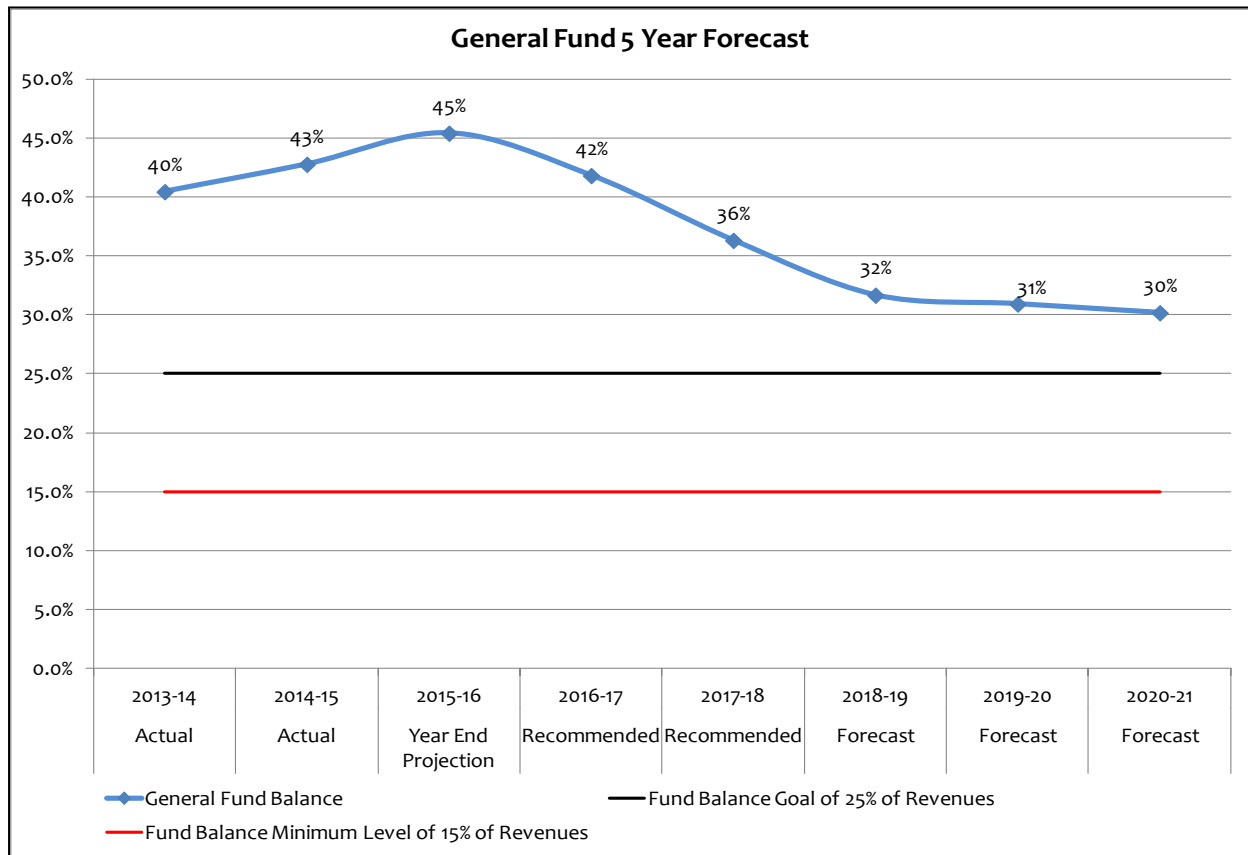


Sales tax revenue, is estimated to decrease approximately 4 percent in FY 16-17 compared to FY 15-16 year end projection, primarily due to ending of triple-flip and true-up payment to occur in FY 15-16. For FY 17-18, sales tax revenue is expected to increase by 4 percent compared to FY 16-17, largely due to continued moderate economic growth forecasted for the region and new business growth. Subsequent forecast years assume an average annual growth of approximately 4 percent. From a property and sales tax perspective, it is important to understand that the City only receives a small portion of the total taxes paid by residents, businesses, and visitors as depicted in the following images.









From a dollar standpoint, the GF's fund balance is forecasted to decrease from \$16.3 million at the conclusion of FY 15-16 to \$12.5 million by the end of FY 20-21 primarily due to the aforementioned additional investments in the City's street infrastructure, gradually restoring staffing levels in high priority areas, and addressing unfunded OPEB and PERS liabilities (all of which are further explained in subsequent sections of the Budget Message).

## General Fund 5 Year Forecast

(in millions of dollars)

	15-16 YEP	16-17 Rec	17-18 Rec	18-19 Forecast	19-20 Forecast	20-21 Forecast
Beginning Balance	\$15.0	\$16.3	\$15.1	\$13.4	\$12.3	\$12.4
Revenues/Transfers In	36.0	36.1	37.0	39.0	40.2	41.5
Expenditures/Transfers Out*	(34.7)	(37.3)	(38.7)	(40.1)	(40.1)	(41.4)
Ending Balance	\$16.3	\$15.1	\$13.4	\$12.3	\$12.4	\$12.5
<b>GF Fund Balance/Reserves (%)</b>	<b>45%</b>	<b>42%</b>	<b>36%</b>	<b>32%</b>	<b>31%</b>	<b>30%</b>
Operating Margin	\$1.3	\$(1.2)	\$(1.7)	\$(1.1)	\$0.1	\$0.1

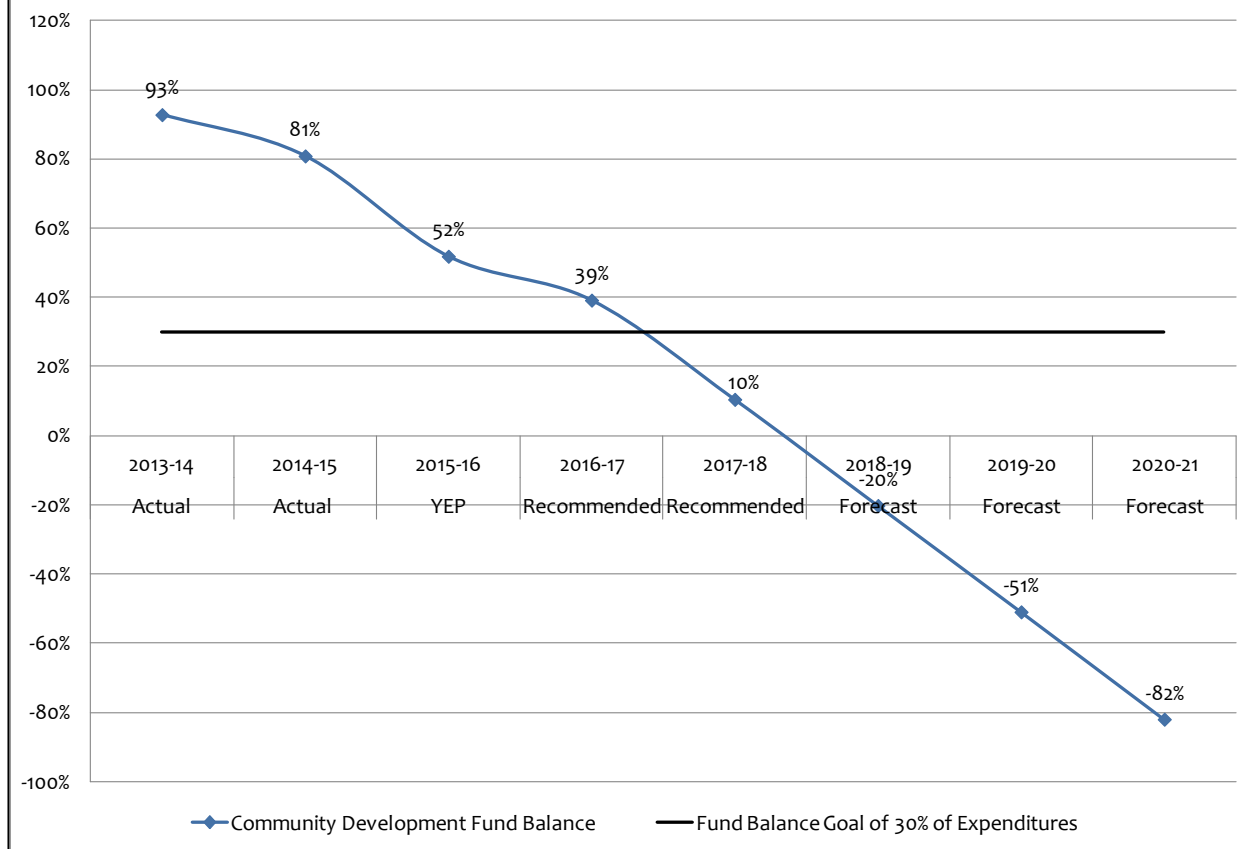
\*Includes Anticipated Salary Savings

CITY OF MORGAN HILL • FY 16-17 and 17-18 • OPERATING AND CIP BUDGET • CITY OF MORGAN HILL

The General Fund expense budget is \$37.7 million and \$38.9 million for FY 16-17 and FY 17-18, respectively. FY 16-17 salaries and benefits increased 8 percent or \$1.4 million from last year amended budget primarily due to scheduled pay increases per MOU, pension and health premium costs, additional funding of 3 full-time equivalents (FTEs), and non-benefitted part-time positions including the recently approved State minimum wage increases. For FY 17-18, salaries and benefits increased 4 percent or \$0.8 million compared to Recommended FY 16-17 primarily due to aforementioned reasons but without new FTE. The non personnel budget for the General Fund in the Recommended Biennial Budget increased 2 percent or \$329,000 for FY 16-17 compared to FY 15-16 Amended Budget mainly due to an increase in the annual General Fund investment for street improvement projects from \$750,000 to \$1,000,000, funds set aside to address the City's unfunded OPEB and pension liabilities, and service enhancements, partially offset by reduction in supplies and services. Non personnel budget for FY 17-18 increased incrementally, 2 percent or \$379,000 from FY 16-17 mainly due to overall cost inflation factor. With this being said, it is important for the Council and community to understand that the City is not yet in the financial position to address its aging public infrastructure (streets, facilities, parks) in an ongoing manner that significantly reduces its deferred maintenance backlog or decreases the level of annual decline. As demonstrated below, Morgan Hill has the lowest General Fund expenditures per capita compared to a sample of surrounding cities.



## Community Development 5 Year Forecast



22



The Community Development Fund expense budget is \$5.1 million for both FY 16-17 and FY 17-18, a decrease of 9 percent from last year primarily due to the completion of significant items such as the implementation of an integrated, electronic permit tracking system.

(in millions of dollars)						
	15-16 YEP	16-17 Rec	17-18 Rec	18-19 Forecast	19-20 Forecast	20-21 Forecast
Beginning Balance	\$3.7	\$2.7	\$2.0	\$0.5	\$(1.1)	\$(2.8)
Revenues/Transfers In	4.3	4.4	3.7	3.7	3.8	3.8
Expenditures/Transfers Out	(5.3)	(5.1)	(5.1)	(5.4)	(5.5)	(5.7)
Ending Balance	\$2.7	\$2.0	\$0.5	\$(1.1)	\$(2.8)	\$(4.7)
<b>Fund Balance/Expenditure (%)</b>	<b>52%</b>	<b>39%</b>	<b>10%</b>	<b>(20%)</b>	<b>(51%)</b>	<b>(82%)</b>
Operating Margin	\$(1.0)	\$(0.7)	\$(1.5)	\$(1.6)	\$(1.7)	\$(1.8)

The Water and Wastewater Utilities are enterprise funds that derive all of their operating revenue from customer charges. As a result of the January 2016 rate studies, the Council approved a five year annual rates adjustment plan to ensure that public safety and health remain a priority, the integrity and reliability of these essential community assets can be maintained, and aging and inefficient infrastructure replaced. In addition, the approved rate adjustments provide proper reserve levels in accordance with Council policy and continue meeting legally required debt coverage.

With the approved rate adjustments, the City's Water revenue is forecasted to steadily increase from \$10.0 million in FY 16-17 to \$15.5 million in FY 20-21 and for Wastewater from \$10.4 million in FY 16-17 to \$12.2 million in FY 20-21. As summarized in the table below, the Water Operations is forecasted to continue tapping into its reserve to fund its operations in the short term and fall below Council's 30 percent reserve policy. By FY 17-18, revenues would begin to exceed expenditures and start generating surplus to allow the fund to begin building up its reserve to meet reserve fund targets set by City Council. The fund is forecasted to meet Council's reserve policy by FY 20-21.

## Water Operating Fund 5 Year Forecast

(in millions of dollars)

	15-16 YEP	16-17 REC	17-18 REC	18-19 Forecast	19-20 Forecast	20-21 Forecast
Beginning Balance	\$2.7	\$1.5	\$0.8	\$1.2	\$1.7	\$3.0
Revenues/Transfers In	8.8	10.0	12.2	13.3	14.5	15.5
Expenditures/Transfers Out	(10.0)	(10.7)	(11.8)	(12.8)	(13.2)	(14.8)
Ending Balance	\$1.5	\$0.8	\$1.2	\$1.7	\$3.0	\$3.7
Fund Balance/Expenditure (%)	15%	7%	10%	13%	23%	25%
Operating Margin	\$(1.2)	\$(0.7)	\$0.4	\$0.5	\$1.3	\$0.7

Unlike the water fund, the wastewater fund, including rate stabilization and system replacement fund reserves, is projected to have a healthy beginning fund balance of approximately \$8.2 million. Also, unlike the water fund, the drought conditions that have significantly impacted the water fund due to reduced water consumption have had a minimal impact on the wastewater fund because rates are set from a three month average of water consumption during the winter months, which is typically the lowest period of water consumption. As a result, the Council has made the determination that the previously adopted 3.5% rate adjustment that would have gone into effect January 1, 2016 for wastewater not be implemented. The Council has approved nominal rate adjustments over the next five years.

## Wastewater Operating Fund 5 Year Forecast

(in millions of dollars)

	15-16 YEP	16-17 REC	17-18 REC	18-19 Forecast	19-20 Forecast	20-21 Forecast
Beginning Balance	\$4.3	\$2.9	\$2.6	\$2.7	\$2.8	\$2.9
Revenues/Transfers In	10.1	10.4	10.8	11.3	11.7	12.2
Expenditures/Transfers Out	(11.6)	(10.6)	(10.7)	(11.2)	(11.6)	(12.1)
Ending Balance	\$2.9	\$2.6	\$2.7	\$2.8	\$2.9	\$3.0
<b>Fund Balance/Expenditure (%)</b>	<b>25%</b>	<b>25%</b>	<b>25%</b>	<b>25%</b>	<b>25%</b>	<b>25%</b>
Operating Margin	-\$1.5	-\$0.2	\$0.1	\$0.1	\$0.1	\$0.1

## Housing

Even though several years have passed since the dissolution of Redevelopment Agencies (RDA) by the State of California, the City's Housing program is still dealing with the loss of \$4 million in annual funding to support the rehabilitation and development of affordable housing in Morgan Hill. These housing funds were one of the significant cornerstones of the City's very successful housing program, and made possible most of the City's housing programs.





- ## Public Infrastructure

More specifically for its streets, the City uses the industry standard Pavement Condition Index (PCI) to evaluate street condition and has a goal to have the PCI of 70+. Since 2012, the City's PCI has dropped from 76 to 67 and is now considered "at risk." The current level of funding will result in further PCI decline. The *Infrastructure Report* identified a \$4.5 million annual shortfall in streets and roads maintenance funding to improve PCI into the low 70s.





The Council's Long-Term Labor Policy, Principles, and Strategies' Principle No. 4 – Fiscal Sustainability and Economic Climate states that “all compensation commitments must be made consistent with principles of fiscal sustainability and to ensure the City's long term success in achieving its mission.” As part of this principle, “the City will strive to hire contract employees instead of full-time benefitted employees to allow for greater flexibility during periods of peak demand.” Since adopted in 2011, the City has adhered to this principle throughout the organization and especially in development services. The City has contracted to augment its team in the planning, engineering, and building functions to ensure we have the necessary resources to satisfy the expectations of the development community.

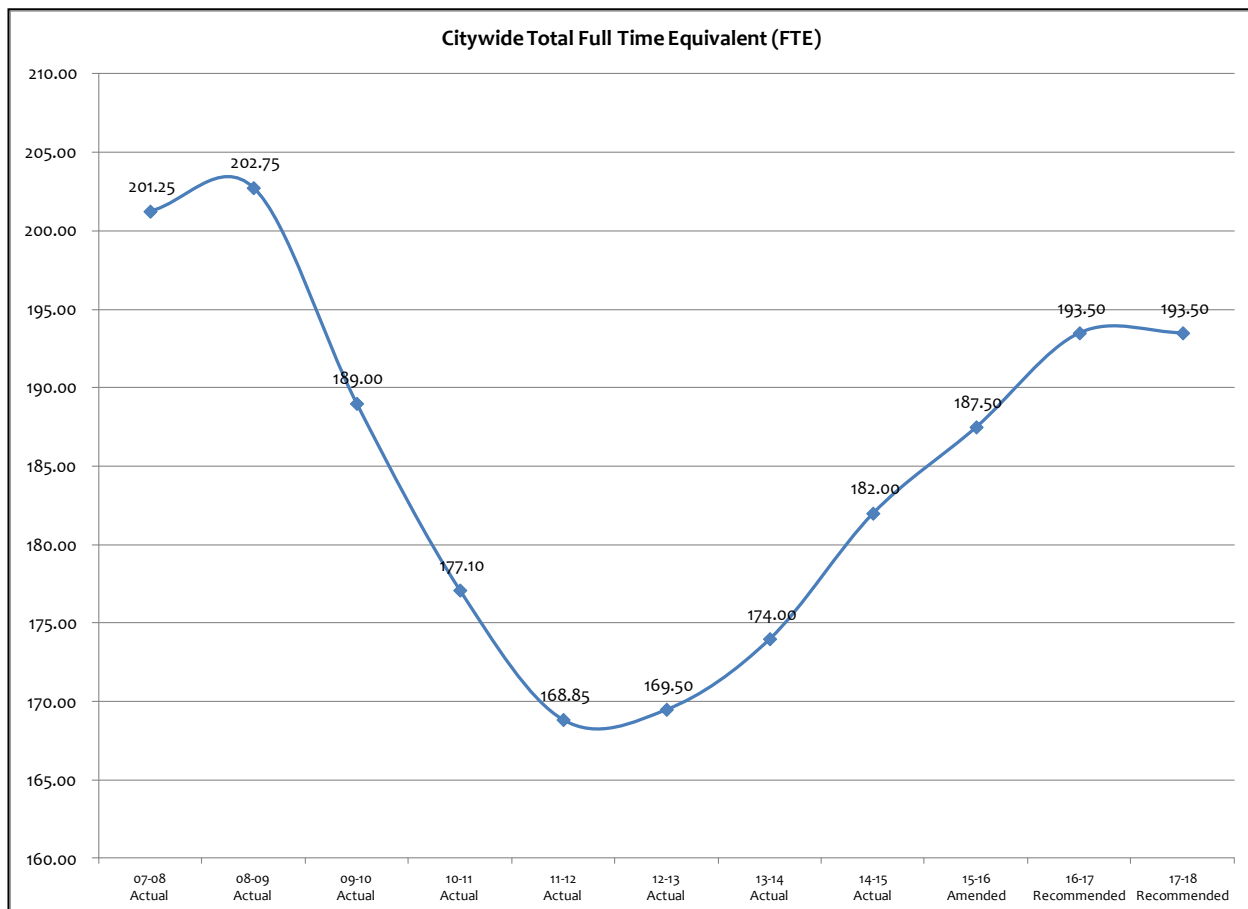
Beginning in FY 16-17, the following personnel are being proposed to enhance services.

- Public Safety Dispatch Supervisor (1 FTE) in the Police Department to supervise and manage the day-to-day operations of the communication center and to ensure the center's operational effectiveness
- GIS/Land Use Data Administrator (1 FTE) in Community Development responsible for the design, operation, and administration of Citywide GIS infrastructure
- Accounting Manager (1 FTE) in the Finance Division to enhance service delivery and internal control procedures
- Public Works Inspector (1 FTE) and Senior Project Manager (1 FTE) in the Public Works Department to deliver CIP projects and increase the level of resources dedicated to development services (entirely offset by reducing contractual services in a greater amount for each position).

- Municipal Services Assistant position (1 FTE) in the Building and Code Compliance Divisions

## Reclassify Existing Position:

- Reclassify Assistant Finance Director to Director; Economic Development Manager to Director; Human Resources Manager to Director; and Council Services and Records Coordinator to Manager as each of these positions' responsibilities has evolved to a higher level to meet the needs of our community and customers.



During the Great Recession, the City reduced approximately 34 positions or over 17 percent of its workforce. The City has managed to improve efficiencies, to do more with less staff, but this has continued to place a strain on the organization as the workload continues to be heavy and in many cases, increasing. While the rebounded economy has stabilized the City's General Fund budget, the City needs to enhance

## Number of Residents/FTE

The chart displays the number of residents per full-time employee (FTE) for five cities over a five-year period. Morgan Hill consistently has the highest ratio, starting at approximately 295 and ending at 293. Milpitas shows a significant increase from 175 to 230. Gilroy remains relatively stable between 210 and 220. San Jose and Mountain View have the lowest ratios, with San Jose slightly higher than Mountain View, both showing minor fluctuations.

Fiscal Year	Morgan Hill	Gilroy	Milpitas	Mountain View	San Jose
FY11-12	295	212	175	128	178
FY12-13	303	220	215	135	178
FY13-14	299	210	225	135	178
FY14-15	297	220	230	133	180
FY15-16	293	210	230	133	175

In addition, the City has evaluated the increase in General Fund employee expenses with revenue growth to ensure that long term sustainability is achieved. As demonstrated below, projected growth in revenue and total General Fund employee compensation is equal in the final years of the five year forecast.





officers is 35.963 percent of pay, lower than CalPERS required employer's contribution due to the 3.263 percent shared by our employees. The projected City's contribution for sworn police officers for FY 17-18 is 41.412 percent (37.056 percent City-paid and 4.356 percent employee-paid). These amounts are in addition to the employees' 9 percent of pay contribution to their own retirement. For all other employees, the employer's required contribution is 19.887 percent of pay (18.135 percent City-paid and 1.752 percent employee-paid—in addition to the employees' 8 percent of pay contribution to their own retirement) for FY 16-17 and 20.9 percent of pay is forecasted for FY 17-18 (18.642 percent City-paid and 2.258 percent employee-paid). The most recent CalPERS contribution rate projections for FY 20-21 are 46.51 percent for the Safety Group and 23.1 percent for the Miscellaneous Group, respectively. These figures have been included in the five year forecast, although as noted above, half of the increase is to be paid by employees under the pension cost-sharing agreement reached in 2013.

Furthermore, new State law became effective in January 2013 that changed CalPERS pensions for “new employees” that is known as PEPPRA (Public Employee Pension Reform Act). Since the majority of Morgan Hill’s employees are not impacted by these changes, any cost savings will be realized only over time as new employees (who are not current CalPERS members through another public agency) join the organization. Currently, 29 full-time employees (or 16 percent of the approved full-time positions) are classified as new employees for pension purposes. This is up from 21 full-time employees (or 11 percent) one year ago.

## Summary

On behalf of the entire organization, I am proud to recommend the City's first two-year operating budget and six year CIP that reflects the City Council's and community's priorities and strives to enhance service levels. The City is able to maintain its positive General Fund financial condition due to the fiscally responsible actions taken in the prior fiscal years and by continuing to adhere to its sustainable budget strategy, prudently investing in service level enhancements as resources allow, and addressing areas of financial concern. As a result of the budget recommendation, the City will invest additional near term funding for maintaining its street and public facility infrastructure, enhance its public safety services, provide quality youth and senior services, continue to address its unfunded OPEB and pension obligations, and undertake many exciting and needed capital improvement projects. Moving forward, there are many signs that the Morgan Hill community will prosper. At the same time, the Council and staff will need to continue to engage our community. This community focused effort will allow us to meet our community's needs and maintain our high quality of life, so that Morgan Hill remains a highly desirable place to live, work, play, and do business.

Sincerely,

Steve A. Rymu

Steve Rymer  
City Manager